SUNDARAM BNP PARIBAS
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MARKET OUTLOOK

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The Long Shadow of Global Linkages

Sentiment and liquidity in the equity market continue to be impaired by developments in the U.S, and increasingly, parts of Europe. India is not alone in the turmoil; it is, however, among markets that have lost the most in 2008 year-to-date. *The phase of consolidation marked by high degree of volatility is likely to continue for the next few months* till there is clarity that the worst in terms of news flow from U.S economy and global financial players is behind us.

In the domestic context, the market has not taken kindly to the Rs 60,000 crore loan waiver announced for farmers in the budget by the Finance Minister, P Chidambaram. The fear is probably more about a fresh bout competitive populism rather than just the budget proposal as such. The lack of clarity on how the banks will be compensated – wholly or partially, the more likely outcome – has also not helped sentiment towards banking stocks. Our broad view on the budget and also implications of specific measures is available at www.sundarambnpparibas.in.

Bird's Eye View: We have a cautious view on our near-term outlook. *Risk aversion is pervasive across markets and this situation is not likely to change over the next few months.* A corrective phase in terms of market levels and time is likely to be healthy; the more so as it has already helped eject excesses in valuation levels in specific stocks, the significant speculative build-up in futures and options and the showcased as well as the less-known primary market offerings at bloated prices.

The **incremental risks** from a medium-term perspective are earnings downgrades in India, elevated levels of crude prices, a possible increase in the current account deficit and a slowdown in China.

Our view on the long-term outlook for the Indian economy and market is, however, as positive as it has been for several years.

Global linkages at work: The U.S may be gradually ceding its level of importance in the global economic context. This is, however, a process that is likely to happen only over several years and that explains why continuing negative developments in its economy have now cast a long shadow across the globe.

The vulnerability of the India to a U.S recession is relatively limited as compared to other emerging markets as far as economy is concerned The markets are a different kettle of fish. As highlighted in our India Outlook 2008 document, the global linkages of the markets and its implications are significant and this is unlikely to change anytime soon.

India had delivered blockbuster returns in the second half of 2007. Secular rupee appreciation and the completion of five years of a bullish phase with average annual returns of about 45% for the Sensex portfolio have also meant attractive in-the-money positions for investors who had entered anytime before July 2007.

In this context, as risk aversion has taken hold and impacted sentiment and liquidity, *India was always likely to be in the frontline of fire when foreign investors decided to take profits. That phase is underway now.*

Recession fears, the trigger: That the U.S economy was headed for a difficult period has been highlighted in our Market Outlook for a year now and to that extent, the emerging news flow is not a surprise. It was always going to be tough to exactly pinpoint when it could impinge on the markets; the effects have been postponed till early 2008 only by the gush of liquidity and a state of bliss that dominated trends across the world between August and December last year.

The U.S now appears to have stepped into a recession, though the birth date is likely be anointed, as always, a few months after the event start. Even in the October-December quarter, if one strips out the effect of export, aided by a rapidly sliding dollar, the domestic economy in the U.S suffered a contraction. This trend is likely to be accentuated in the first half of 2008. The near-desperate pace of rate-cuts by the U.S Federal Reserve may take time to take effect on the ground and may only help in moderating the extent and not the recession. Worryingly, this phase of rate cuts is now accompanied by inflation levels elevated above comfort levels of central banks in developed markets. Notably the European Central Bank has so far steered clear of rate cuts, preferring to place emphasis on looming inflation rather than the threat of imminent slower growth.

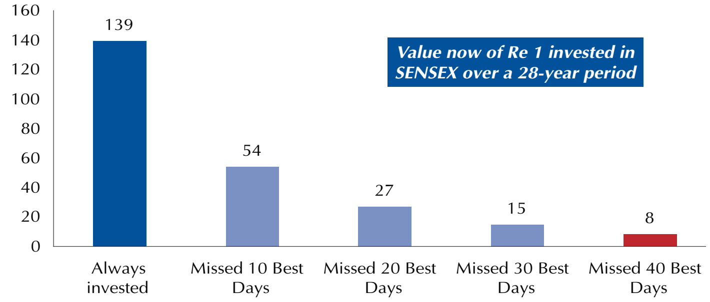
Multiple legs for credit crisis: The crisis that came to the fore via sub-prime has enveloped several parts of the credit market. *Just in the past month, at least three more parts of the credit market have joined the woes party now inflicting significant damage* across a wider swathe of institutions. In this context, the write-off for poor quality credit assets at global financial majors, that is now approaching $-200 billion mark, may have substantial headroom to rise and we could expect news flow, including on institutional collapse (we have already had one major such event in the U.K) through 2008.

The ongoing massive write-offs will have an impact on credit flow to the economy due to erosion in capital and this consequence may not be neutralized by the Fed rate cuts. The magnitude of the still-unfolding crisis is clear from proposals, which would normally be labeled as desperate and reeking of moral hazard, from persons in high office.

The crisis will have to run its course so that pain is taken out and this will continue to impact emerging markets across the board and economies in varying degree. This is why this round of market correction in India may not reverse as quickly as similar events in May 2004 and May 2006 though its economy may be among the least affected among emerging markets.

Market Outlook

Benefit of disciplined long-term investing



Significant gains only if you had remained invested at all times

Daily Returns since launch to February 2008

Rs.1000-a-month SIP between 1997-2006: is now worth Rs 5 lakh

Investment in lacklustre phases accounts for 75% of wealth creation

Year	Nature of Market	Average Sensex Value	Share in Wealth (%)
1997	Lacklustre, Poor Depth	3774	11.5
1998	Lacklustre, Poor Depth	3356	13.0
1999	Lacklustre, tech boom starts	3990	11.0
2000	Tech-led boom & bust	4637	9.4
2001	Lacklustre, Poor Depth	3519	12.4
2002	Lacklustre, Poor Depth	3241	13.3
2003	Lacklustre First Half	3789	11.7
2004	Bull market continues	5535	7.8
2005	More strength to bullsih phase	7313	6.0
2006	Bullish phase	11345	3.8

Value of SIP reckoned as on February 29, 2008

Growth trends in India: The higher interest rates – ushered in the second half of 2006-07 - that started to affect demand in select sectors such as real estate, auto and consumer durables from a few months ago stays a key factor. As a result, GDP growth has slipped below 9% for the last quarter of 2007; the guidance from the government is now for 8.7% growth in GDP for FY 08; the RBI has stuck to 8.5%.

There will be a further slowdown in FY 09 linked to domestic and global factors. We expect growth to, however, stay above the 8% trajectory. This will still be a healthy number coming on the back of an average growth of 8.5% over the preceding five years.

The emphasis on having inflation under check, even if it means sacrificing growth to an extent, is healthy from a long-term perspective. This could lead to a more sustainable level of GDP growth than in an environment that allows inflation to flourish.

The fiscal measures announced in the budget – cuts in excise duty, sizeable relief on income tax, the stimulus for rural growth and loan waiver for farmers plus the imminent Sixth Pay Commission-linked pay hikes for government employees – could provide a boost to consumption and manufacturing a few months down the road. This could help moderate the imminent decline in GDP in FY 09, as the measures provide a fillip for growth in manufacturing that has tapered in recent months.

Focus on check on inflation: Neither the RBI nor the government is likely go easy on the battle on inflation; the more so as WPI numbers have edged higher and closer to RBI's immediate comfort zone and farther from its medium-term target zone. The headwinds – especially from global trends in soft commodity and crude prices – also reduce the likelihood of meaningful rate cuts in the near term.

Equity outlook: In this backdrop, equities are likely to move in a narrow range accompanied by high volatility. As the global news flow continues to torment markets, there may also be a modest downward bias from present levels. In our note dated January 22, 2008 when the Sensex slipped to 15300 on an intra-day basis, we had highlighted that markets would be attractive at that level from a valuation perspective. This may, however, not trigger significant buying unless risk appetite improves; this is more likely in the second half once there is comfort that the worst is over.

Interestingly in the past few weeks, even big-ticket names on sell-side research have turned negative on India. This is not necessarily a firm indication of what is to come, as the first $ 10 billion in 2007 sought Indian equities when several global majors had a negative stance on India.

Fixed-Income Outlook: We expect this month to reflect the usual March tendency of tight liquidity, over supply by certificates of deposits to prop up balance sheet sizes, significant advance-tax outflows and a spill over effect of all these factors on bond and money markets. There was relief when the Budget for the 2008-09 was presented in Parliament as the expected net Central Government borrowing, at about Rs.1,00,000 crore, came in at a level far lower than what was feared by the market.

The clarification on the SLR status for \oil bonds is awaited. As the spread of these bonds is higher by 70 basis points compared to G-Secs, any improvement in status will place the oil bonds as an alternate investment option for meeting SLR requirement. This will move up the G-Sec yields, which is a major risk to the market at present.

Investment Approach: The phase of correction and consolidation now provides investors a more attractive entry point from a long-term perspective. It may not be appropriate to try and catch the bottom of the market as such timing efforts often tend to go awry even for persons with considerable market expertise. It may also lead to missing critical market days that could make a world of difference to wealth creation (refer graphic on ` Benefits of disciplined long-term investing).

An SIP (Systematic Investment Plan) approach may be appropriate and this year may be good for investors using this route. Sample for instance, the wealth created for an investor doing a monthly SIP in the decade between 1997 and 2006 depicted in the accompanying table. This period was marked by five different phases for the market. The biggest contribution to the wealth creation has come from disciplined investing during the difficult years.

A disciplined approach towards investing and staying invested across market phases, realistic expectation of returns and a long-term approach will help investors build on the gains of the five-year bull market.

View of Sundaram BNP Paribas Asset Management

Completed on March 5, 2008

Does 2 + 2 = 5 - 1 or 6 – 2?

Experienced equity and other risky financial assets investors have long known that very few markets rise steadily over time like a linear function. Other investors have no doubt learned it recently. In the current troubled macro and microeconomic environment, where almost every argument in favour of rising equity prices is being challenged, the key question is whether share prices have already hit the bottom or whether we should brace ourselves for a further drop.

Expressed in mathematical terms, this boils down to determining whether 2 + 2 will equal 5 - 1 (which roughly represents the recent correction in equity markets and is comparable to the average "recession" correction [2]), or perhaps 6 - 2 or even worse. However, bearing in mind the old stock market saying that "only monkeys pick bottoms" [3] and convinced that we no longer have anything to do with our prehistoric ancestors [4], we certainly will not try to do so, while endeavouring however to get a better understanding of the situation.

So we will not get into any arguments as to whether a decrease in equity prices from -19.9% to -20.1% marks the transition from a "bull" to a "bear" market", nor start splitting hairs as to whether the US economy is or is not in a recession. Instead, we will try to clarify our views on two macroeconomic and financial topics that are the subject of much debate and are critical to any investment scenario.

The first has to do with economic "decoupling" between the emerging and developed economies. Is this still a relevant concept or must we now start envisaging a "recoupling" between the North and the South? The second question we will examine is whether equities are reasonably valued in light of current earnings forecasts or still too expensive. **To summarize our views, we believe the first responses to both questions are the most likely, which of course supports the idea that equities are currently at or near their lows**.

ECONOMIC DECOUPLING STILL VALID

The bad news keeps coming. The latest concerns the funding difficulties that “monoliners” are facing due to actual or potential downgrades from credit-rating agencies, whose newfound zeal during crisis periods make these worse. In any case, now we know where the rest of the subprime-related losses were hiding... If “monoliners” succeed in honouring their guarantees this will hurt their balance sheets. If not, their financial counterparties will have to increase their provisions even more. Rescue operations are being put in place and a bailout of the "monoliners" seems likely, since all other alternatives look much more expensive for the whole financial sector.

Nevertheless, given the complexity of the financial assets involved and the funding difficulties that many banks are facing many questions still remain. News on the economic front is hardly more encouraging. The US economy seems to be weakening every day, and most market observers expect nearly no growth in the first half of 2008. **The slowly yet steadily declining jobs market is now the main concern** rather than the very surprising drop in the ISM non-manufacturing index. However, the situation cannot be said to be dramatic, with wage growth at almost 4% and the jobless rate near NAIRU. Other large developed economies, such as Japan, the euro zone and the UK, are also feeling the pinch from the US downturn and the slowing global economy, particularly since their currencies have generally appreciated in effective terms.

It goes without saying that the emerging economies will not be completely spared from the marked cyclical slowdown in the major developed countries and regions. But as we have already explained in late 2006 [5], given the fundamental structural trends inherent in the long-term development of the emerging countries, we still believe we will see substantial economic independence, i.e. a decoupling between the South and North. Of course, **economic decoupling does not necessarily mean decoupling between financial markets**. Moreover, the correlation between developed and emerging equity markets, barring any crisis in the latter, has always been about 80%, even though it has increased somewhat recently [6].

Let us now examine the two main arguments in support of the decoupling theme between the developed and the emerging economies.

Over the past few years, unlike what many people still believe, the robustness of emerging country exports depended more on the rapid growth of intra-regional trade than on G-7 countries. China replaced the United States as the main purchaser of emerging country exports and currently exports fewer goods to the US than to the rest of Asia. Of course, the fact that China is now the world's "manufacturing hub" or "Asia's factory" explains much of this shift in intra-regional trade. However, the still large gap between production costs in the North and South means not only that the emerging economies will gain market share as global demand slows, but also that the transfer of production capacity to the emerging countries will continue and even accelerate. These two effects will considerably reduce the negative impact of weaker global growth on domestic demand in the emerging economies.

Another force that will transfer production capacity is the stronger endogenous demand in most of the large emerging countries. Driven by the need to "catch up" with the developed economies, the growth of emerging domestic demand is largely structural. The high level of investment also generates technological progress and therefore larger gains in productivity. GDP growth potential is also boosted by the migration of rural populations to cities, which accelerates the growth of the labour force. A higher potential growth rate means higher incomes and therefore stronger demand [7]. An incidental **consequence of this stronger demand in the emerging countries is the increase in commodity prices and therefore in income for commodity producers, most of which are in the emerging countries. Sort of a virtuous cycle you might say!**

EQUITY VALUATIONS ATTRACTIVE

Our continued belief in economic decoupling between the North and South has important implications, since it supports the idea that global economic activity is less dependent on the United States (and therefore more resilient) and that global earnings growth will be more robust. It also almost certainly explains why American non-financial firms' earnings have been relatively strong, growing slightly above 12% in the fourth quarter of 2007 as said by preliminary estimates. It should be noted that according to national accounts **US companies make about a third of their profits abroad**.

It is also important to note that government officials have not been twiddling their thumbs. To reduce the impact of the housing market crisis and its financial consequences, the Fed has already slashed interest rates and will continue to reduce them. **History shows that equity markets never reacted negatively to monetary stimulus, as they (correctly) anticipated better times for both economic growth and profits.**

Furthermore, in addition to the current monetary easing, the US government will be launching a major fiscal plan totalling approximately 1% of GDP [8]. In short, although we may be sceptical about analysts' earnings growth forecasts – they predict for example a 17% increase for the S&P 500 in 2008 – there is no reason to be too pessimistic and to believe earnings will inevitably plunge into negative territory. This is of course based on our assumption that a global recession will be avoided. However, **a little math shows that financial markets already seem to expect a collapse in corporate earnings**.

For example, in order for the mean trailing P/E in the US to return to its long-term trend of 18, earnings would have to drop 25% in 2008! A similar drop in the cyclically-adjusted earnings of the MSCI global index would only increase P/E to 16, compared to a long-term trend of 20. The fact that dividend yields are on par with long-term bond yields in Europe, Japan and the US (when share buybacks are included) is also quite unusual.

Furthermore, a closer look at equity indices also reveals more anomalies. For example, over 20% of S&P 500 firms with a market capitalization above $5 billion (and not only in the financial sector), are trading below book value. An unprecedented 15% of Topix firms are now trading at a P/E of less than 10. Even ignoring relative valuations at record levels in favour of equities, the number of technical indicators in "oversold" territory or the high levels of risk-aversion, equities certainly do appear to be cheap.

On the basis of the above and of the fact that the balance sheets of non-financial firms remain solid, we can conclude that the market is more likely to have hit bottom than to fall further, and favour the "2 + 2 = 5 - 1" to the "2 + 2 = 6 - 2". Accordingly **we do not think it would be wise to reduce our exposure to equities any further**. Nevertheless, since valuations alone are rarely enough to trigger an upturn in equity markets and since the financial sector and therefore the real economy continue to face substantial risks, **we are in no hurry to increase our position in equities or adjust the cyclical composition of our portfolio**.

Indeed, we continue to fear that negative economic and financial news (or positive news that is interpreted negatively) may unsettle equity markets in the current environment where investors are still quite nervous. We therefore prefer to wait a bit until the dust settles before returning to this asset class. By the same token, we are also avoiding under-exposure to government bonds, even though they do seem too expensive. We also made few directional or relative changes in other asset classes. Although **there has been a lot of dust flying around, much of it now seems to have almost reached the ground**.

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[1] Or 7 - 3 or 8 - 4 etc. The title of this Editorial was inspired by Jean Boissonnat, who during the BFM radio show "Good Morning Business" on January 18, said that 2 + 2 equity markets currently equalled 5 - 1.

[2] Using the S&P 500 as our benchmark.

[3] It was Ian Scott, a strategist at Lehman Brothers, who reminded us of this perhaps too often ignored saying.

[4] Even though the very imaginative writer Bernard Werber very convincingly submits the idea that humans descend from pigs, in his book "the Father of our Fathers", almost everyone agrees with the official theory that we descend from monkeys.

[5] See our editorial of 15 November 2006 entitled "The Global Post-It Trend! "

[6] It should also be noted that when financial markets go through turmoil, and therefore substantial drops, correlations tend to rise. These rising correlations during times of crisis may largely be attributed to the increasing use of various risk models, such as VaR.

(7) We also pointed out last month (see "Is Kaa up to his Old Tricks?") that rising productivity in the lower-income emerging countries would bring their cost of living in line with that of the richer countries. However, this is likely to take some time.

(8) [In this environment it is easier to understand the saying "Don't Fight The Fed", which is one of Wall Street's golden rules. And if the government also provides fiscal stimulus…

View of BNP Paribas Asset Management

N Prasad is the Deputy CEO and has an experience of nearly 15 years in the financial markets, straddling equity research and fund management. A Post-Graduate in Commerce, he started his career with Canara Bank before moving to the then-nascent fund management industry at the turn of the 90s. After stints with Canbank Mutual and ICICI Mutual as fund manager, Prasad joined our fund house in 1996 as Chief Investment Officer.

Satish Ramanathan, a CFA Charter Holder, is the Head-Equities. He is a graduate from IIT-Madras who has specialised in Finance & MIS in his MBA. He has extensive experience in the asset management business with stints in Research division of Sundaram AMC and managing funds for Franklin Templeton. He has been involved in equity research for more than a decade and brings expertise in tracking several key sectors in the Indian economy.

Satish Ramanathan manages Select Mid Cap, Tax Saver, Select Small Cap, Equity Multiplier and the equity portfolio of the Balanced Fund and Monthly Income Plan.

K. Ramkumar is the Head-Fixed Income. He is a science graduate from Madras University and a Cost Accountant. He is a Certified Associate of Indian Institute of Bankers and has done Diploma in Business Finance from the ICFAI, Hyderabad. He has over 15 years experience in the Mutual Fund Industry. His prior experience includes 12 years with UTI Mutual Fund and 4 years with SBI Funds Management.

Ramkumar manages Floating Rate – Short Term, Floating Rate – Long Term, Bond Saver, Monthly Income Plan and Value Plus. He is also the Co-Fund Manager for Liquid Plus & Fixed Term Plans.

Srividhya Rajesh, a CFA Charter Holder, focuses on the equity markets. She is also a management graduate from BITS Pilani and has done specialized courses in equity research and financial applications from ICFAI, Hyderabad. She has been with us from the time the fund house started operations in 1996. A two-year stint at the broking arm Kotak Mahindra opened a window to the equity markets.

Srividhya Rajesh manages Select Focus, Capex Opportunities and equity portfolio of Value Plus.

S Krishnakumar is the Head-Research. An engineer from REC (now National Institute of Technology), Trichy, he did an MBA from LIBA, Chennai. He has worked for 18 years of which the latest eleven years relate to the equity markets. Before joining our fund house, he was Vice President (Research) at Anush Shares & Securities.

Krishnakumar is the Fund Manager for the S.M.I.L.E Fund, Energy Opportunities and Tax Saver 98

J Venkatesan, a Cost Accountant and a Post-Graduate in Commerce, has an experience of more than two decades in the banking and asset management businesses. A seven-year stint at Canara Bank was followed by a shift to the asset management industry through Canbank Mutual Fund. With a rich experience of close to ten years in fund management, he joined Sundaram BNP Paribas Asset Management in January 2006.

Venkatesan is the Fund Manager for the Rural India Fund, Growth, India Leadership Fund and Global Advantange.

Rahul Pal focuses on the fixed-income space. He is a Chartered Accountant. A three-year stint at IDBI Treasury provided an apt learning ground on the intricacies of fixed-income market. Rahul then joined Sundaram BNP Paribas Asset Management with an active role in fund management.

Rahul Pal manages Money Fund and the fixed income portfolio of our Balanced Fund. He is the Co-Fund Manager for Liquid Plus & Fixed Term Plans.